KEY POINTS
- Basel III already requires banks to assess the impact of specific environmental risks on a bank's credit and operational risk exposures.
- A recent report suggests Basel III is not being used to its full capacity to address systemic environmental risks.
- China, Brazil and Peru have engaged in a variety of innovative regulatory and market practices to control environmental systemic risks.

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Are environmental risks missing in Basel III?

This article questions whether Basel III should address the macro-prudential or portfolio-wide environmental risks for banks.

The role of the financial system in the economy and broader society is to provide the necessary financing and liquidity for human and economic activity to thrive; not only today but also tomorrow. In other words, its role is to fund a stable and sustainable economy. The role of financial regulators is to ensure that excessive risks that would threaten the stability of the financial system – and hence imperil the stability and sustainability of the economy – are not taken. In the wake of the financial crisis of 2007-08, the G20 initiated at the Pittsburgh Heads of State Summit in September 2009 an extensive reform of banking regulation with the overall aim "to generate strong, sustainable and balanced global growth". At the same time, the Earth's planetary boundaries – defined as thresholds that, if crossed, could generate unacceptable environmental changes for humanity, such as climate change – are under increasing stress and represent a source of increasing cost to the global economy and a potential threat to financial stability. Indeed, World Bank President Jim Yong Kim stated at the World Economic Forum in 2014 that "financial regulators must take the lead in addressing climate change risks".

ENVIRONMENTAL RISKS

An important question arises as to whether international banking regulation (ie Basel III) adequately addresses systemic environmental risks. For example, the macro-prudential economic risks associated with the banking sector's exposure to high carbon assets. Basel III has already taken important steps to address both micro-prudential and macro-prudential systemic risks in the banking sector by increasing capital and liquidity requirements and requiring regulators to challenge banks more in the construction of their risk models and for banks to undergo more frequent and demanding stress tests. Moreover, under Pillar 2, banks must undergo a supervisory review of their corporate governance and risk management practices that aims, among other things, to diversify risk exposures across asset classes and to detect macro-prudential risks across the financial sector. Regarding environmental risks, Basel III already requires banks to assess the impact of specific environmental risks on the bank's credit and operational risks exposures, but these are mainly transaction-specific risks that affect the borrower's ability to repay a loan or address the "deep pockets" doctrine of lender liability for damages and the cost of property clean-up. These transaction specific risks are narrowly defined and do not constitute broader macro-prudential or portfolio-wide risks for the bank that could arise from its exposure to systemic environmental risks.

> "... Basel III already requires banks to assess the impact of specific environmental risks on the bank's credit and operational risks exposures, but these are mainly transaction-specific risks..."

INNOVATIVE PRACTICES

A recent report supported by the United Nations Environment Programme (UNEP) and the University of Cambridge suggests that Basel III is not being used to its full capacity to address systemic environmental risks and that such risks are in the "collective blind spot of bank supervisors". Despite the fact that history demonstrates direct and indirect links between systemic environmental risks and banking sector stability – and that evidence suggests this trend will continue to become more pronounced and complex as environmental sustainability risks grow for the global economy – Basel III has yet to take explicit account of, and therefore only marginally addresses, the environmental risks that could threaten banking sector stability. Despite no action by the Basel Committee to address systemic environmental risks at the international level, some countries – China, Brazil and Peru under the aegis of the International Finance Corporation's Sustainability Banking Network (SBN) – have already engaged in a variety of innovative regulatory and market practices to control environmental systemic risks and adopt practices to mitigate the banking sector's exposure to environmentally unsustainable activity.

These initiatives have been based on existing regulatory mandates to promote financial stability by acting through the

Spotlight

Biog box

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existing Basel III framework to identify and manage banking risks both at the transaction specific level and at the broader portfolio level. What is significant about these various country and market practices is that the regulatory approaches used to enhance the bank's risk assessment fall into two areas: 1) Greater interaction between the regulator and the bank in assessing wider portfolio level financial, social and political risks; and 2) banks' enhanced disclosure to the market regarding their exposures to systemic environmental risks. These innovative regulatory approaches and market practices are the result of pro-active policymakers and regulators adjusting to a changing world. Other international bodies, such as the SBN and UNEP Finance Initiative, have sought to promote further dialogue between practitioners and regulators on environmental sustainability issues and to encourage a better understanding of these issues by financial regulators.

China, Brazil and Peru, among others, have all embarked on innovative risk assessment programmes to assess systemic environmental risks from a macro-prudential perspective as they recognise the materiality of systemic environmental risks to banking stability. The Basel Committee should take notice. ■

Further reading

- Basel III drives changes to capital instruments [2012] 10 JIBFL 636
- Rebuilding international financial regulation [2011] 8 JIBFL 489
- Lexisnexis Financial Services blog: What next for the Basel III leverage ratio framework?